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No. 79-1721

In the Supreme Court of the United States

OCTOBER TERM, 1979

CARLE FOUNDATION, PETITIONER

v.

UNITED STATES OF AMERICA

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

BRIEF FOR THE UNITED STATES IN OPPOSITION

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OPINIONS BELOW

The opinion of the district court (Pet. App. A18-A27), is not officially reported. The opinion of the court of appeals, as amended,[1] is reported at 611 F. 2d 1192.

JURISDICTION

The judgment of the court of appeals was issued on November 29, 1979. On February 1, 1980, the court modified its opinion pursuant to a petition for rehearing filed by petitioner. The court denied rehearing in all other respects on that same date (Pet. App. A14-A15). The petition for a writ of certiorari was filed on April 30,

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[1]The opinion was first issued on November 29, 1979 (Pet. App. A1-A13). The order amending the opinion was issued on February 1, 1980 (Pet. App. A14-A17).

1980. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

QUESTION PRESENTED

Whether sales by a tax-exempt hospital pharmacy to a non-exempt clinic and its private patients constituted unrelated business taxable income under Section 511 of the Internal Revenue Code of 1954.

STATEMENT

Petitioner is organized as an Illinois not-for-profit corporation and is exempt from federal income tax under Section 501(c)(3) of the Internal Revenue Code of 1954 (26 U.S.C.). It owns the Carle Foundation Hospital, of which the Carle Pharmacy is a constituent part. The Carle Clinic Association is a private enterprise conducted by physicians engaged in the practice of medicine for personal profit. The clinic rents space from petitioner. It is not, nor has it ever requested to be, a tax-exempt organization (Pet. App. A1-A2).

With the exception of a small courtesy staff, the hospital is operated exclusively by physicians who are employees of the clinic, where they are engaged in the private practice of medicine. In addition to the medical staff, the hospital and clinic also share some physical facilities, equipment and services. For example, the medical records for all clinic and hospital patients are kept by hospital personnel and are centrally located in the clinic. Clinic facilities are also used for laboratory testing, radiological services, electrocardiograms, electroencephalograms and radioisotope testing for patients of the hospital as well as for private patients of the clinic. Because their doctors are affiliated with the hospital, clinic patients who require hospitalization are admitted to the hospital. Despite these shared facilities and services, however, the clinic and hospital are separate legal entities

(Pet. App. A2). Although the clinic serves, in part, as an outpatient department of the hospital, it also functions to a large extent as doctor's offices, *i.e.*, a place where clinic doctors see their own private patients (R. 110).[2]

The pharmacy supplies pharmaceuticals to the hospital and its patients as well as to the clinic and the clinic's private patients (Pet. App. A2). During its taxable years 1971 and 1972, the pharmacy received more than $800,000 in gross income from sales to other than the exempt hospital and its patients, which yielded net income to petitioner of approximately $150,000 (Pet. App. A22-A23).

On audit, the Internal Revenue Service determined that sales by the pharmacy to the clinic and the clinic's private patients were unrelated to petitioner's exempt purpose and that, therefore, the income derived from such sales is taxable as unrelated business income pursuant to Sections 511 through 513 of the Code.[3] Petitioner paid the resulting tax assessment of $67,266.51 and thereafter commenced this refund suit in the United States District Court for the Eastern District of Illinois (R. 1-15). The district court held for petitioner. It ruled that all of the pharmacy sales to clinic patients and the clinic itself were substantially related to the hospital's exempt purpose. In so holding, the court viewed all clinic patients as hospital outpatients even though the evidence established that a

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[2]"R." refers to the record appendix filed in the court of appeals.

[3]In computing petitioner's tax liability, the Service excluded as tax-exempt the pharmacy's income from sales to the hospital, hospital inpatients, emergency room patients, former inpatients refilling prescriptions, and "hospital-originated" outpatients (Pet. App. A6). The pharmacy maintained records indicating which outpatients were "hospital-originated" and which were "clinic-originated." Only sales to "clinic-originated" outpatients were included in the computation of the unrelated business income tax (Pet. App. A5 n.4).

substantial portion of the patients treated at the clinic were not hospital patients but were simply private patients of the clinic's doctors (R. 104-107, 110-111).

The court of appeals reversed. It held that while the hospital and the clinic in many instances shared facilities and services, they were separate entities so that patients of the clinic could not automatically be regarded as patients of the exempt hospital. As the court viewed the matter, with the exception of pharmaceutical sales to those clinic patients who were actually hospital outpatients, the pharmacy's sales to the clinic and the clinic's patients did not contribute importantly to the hospital's exempt purpose and the income from such sales is therefore taxable as unrelated business income (Pet. App. A11-A13).

ARGUMENT

1. The court of appeals correctly held that petitioner is liable for the unrelated business income tax on the sales by its pharmacy. Sections 511 through 513 of the Code provide that an otherwise tax-exempt organization shall be taxed on income from a regularly operated trade or business which is unrelated to its tax-exempt purpose.[4] There is no question that the pharmacy conducts a trade or business. Hence, the disputed issue is whether the sales by the pharmacy to the profit making clinic and the clinic's patients are substantially related to the hospital's exempt purpose. Under Treasury Regulations, Section 1.513-1(d)(2) (26 C.F.R.), a trade or business is substantially related to an organization's exempt purpose only if the distribution of goods or performance of services from

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[4]The unrelated business tax provisions were enacted primarily to eliminate the unfair competitive advantage enjoyed by businesses conducted by tax-exempt organizations over businesses operated by tax-paying entities. See S. Rep. No. 2375, 81st Cong., 2d Sess. 28-29 (1950).

which the business derives its income contributes importantly to the accomplishment of the organization's tax-exempt purpose. Moreover, whether the organization's income-producing activities contribute importantly to such exempt purpose depends upon the particular facts and circumstances of each case.

Here, petitioner received its tax exemption for the purpose of operating a hospital for the treatment of sick and disabled persons; engaging in scientific research into the causes and treatment of human disease; and training of doctors and other medical personnel (R. 237). As the court of appeals correctly concluded (Pet. App. A10), pharmaceutical sales to persons who are not patients of the hospital do not contribute importantly to the accomplishment of petitioner's exempt purposes. The clinic functions in a dual role. It operates in part as an outpatient department of the hospital. In this context, the clinic's activities are directed toward the accomplishment of petitioner's exempt purpose because in this capacity it serves as an extension of the hospital. Accordingly, pharmaceutical sales to hospital outpatients treated by the clinic are substantially related to petitioner's exempt purpose. They are, therefore, not subject to the unrelated business tax, and the Internal Revenue Service so recognized and excluded such sales from its computation of petitioner's tax liability (Pet. App. A5 n.4). On the other hand, the clinic also functions in substantial part as the offices of private physicians. In this capacity, the clinic does not further petitioner's exempt purpose. The court of appeals therefore correctly held that the pharmacy's sales to or for the benefit of the clinic's private patients are an unrelated business activity under Section

513 of the Code,[5] and are accordingly subject to the unrelated business income tax.

2. Petitioner properly acknowledges (Pet. 3) that the question presented is one of first impression. Indeed, decisions in this type of case largely turn on their own particular facts. Accordingly, no legal issue worthy of review by this Court is presented.[6]

Contrary to petitioner's contention (Pet. 12-16), the unfair competition resulting from the substantial pharmaceutical sales to the clinic's private patients was not the controlling factor in the court's conclusion that such sales are not substantially related to petitioner's exempt purpose. To be sure, the court viewed the substantial profits from the pharmaceutical sales in question as tending to indicate a business rather than an exempt

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[5]As part of the Tax Reform Act of 1969, Pub. L. No. 91-172, 83 Stat. 487, Congress amended Section 513 of the Code and enlarged the category of business activities subject to the unrelated business tax. In this regard, the accompanying Senate Report states (S. Rep. No. 91-552, 91st Cong., 1st Sess. 75 (1969)):

> The Committee amendments approve the intent of the House provision, but restructure the language of the provision so that it will apply only in the case of advertising and certain other profit-making activities carried on within a larger aggregate of activities namely *a sale by a hospital pharmacy of drugs to persons other than hospital patients* * * *. [Emphasis supplied.]

[6]Petitioner also argues (Pet. 16) that the decision below conflicts with the decisions of "numerous other lower courts." But with the exception of *Clarence LaBelle Post No. 217* v. *United States*, 580 F. 2d 270 (8th Cir.), cert. dismissed, 439 U.S. 1040 (1978), the cases cited by petitioner (Pet. 18-19) are trial court decisions. Moreover, *Clarence LaBelle Post No. 217*, is not to the contrary. There, the court held that the absence of any element of unfair competition did not render the tax inapplicable to revenues from bingo games conducted by a post of the Veterans of Foreign Wars. Here, the presence of the element of unfair competition only serves to provide added support for imposition of the unrelated business income tax.

purpose and as establishing the existence of the element of unfair competition at which the tax is aimed. But the court's observations in this respect were entirely proper. See *Iowa State University of Science and Technology* v. *United States*, 500 F. 2d 508 (Ct. Cl. 1974); Treasury Regulations, Section 1.513-1(b). Moreover, the court correctly analyzed (Pet. App. A10-A13) the pharmaceutical sales in light of petitioner's stated exempt purpose of providing health care to its hospital patients in order to ascertain whether those sales were substantially related to the achievement of that purpose. Since the pharmacy's sales to the clinic's private patients, as opposed to hospital outpatients treated at the clinic, do not facilitate the accomplishment of petitioner's exempt purpose, the decision below properly held that they are not substantially related to that purpose. The income was therefore subject to tax.

3. Finally, petitioner (Pet. 11-12) and the amicus Illinois Hospital Association argue that the decision below undermines the cost-cutting procedure adopted by hospitals of treating their patients on an outpatient basis to the maximum extent possible. But the tax assessment in this case only involves those pharmaceutical sales made to non-hospital patients. Sales made to hospital-originated clinic patients, *i.e.*, hospital outpatients, as well as sales to hospital inpatients were not included in the computation of petitioner's unrelated business income tax liability and hence are not involved here. Since the holding in this case is limited to pharmaceutical sales to or for the benefit of the private patients of the physicians who operate the nonexempt clinic, the decision below does not affect the cost of treating hospital patients on an outpatient basis.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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